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ABSTRACT

This document describes the operation of public and private sector mechanisms which work to keep the Canadian economy stable. Part I discusses the many sources of instability in the Canadian economy. Instability is measured primarily in fluctuations in aggregate income or gross national product. Two important contributors to economic fluctuations are industrial economics and business inventory management. Another source of instability is the tendency of business capital investment to accelerate to high levels toward the end of the business cycle or to lag well behind demand requirements due to economic uncertainty. The increasing role of government in the economy and inflationary pressures in the industrial world have also increased economic instability. Part II discusses two main classes of economic stabilizers. These include automatic stabilizers that operate in the economy without any policy initiatives on the part of the government, and the three discretionary stabilizers of fiscal policy, monetary policy, and income policy. The pamphlet concludes with an appraisal of current problems in the application and effectiveness of stabilization policy. (RM)

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Government and the Economy-Stabilization Policies

SO-011313

John W. Popkin

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1977

Government and the Economy

Stabilization Policies

"Stabilization Policies" is the second booklet on *Government and the Economy.*

John W. Popkin, the author of this publication, has been researching and writing about different aspects of economic management for a great many years. In this study, written at the request of the Foundation, he describes the operation of public and private sector stabilizing mechanisms, both automatic and discretionary, which work to keep the economy on an even keel.

He goes on to look at the implementation and effectiveness of traditional stabilization policy in relation to the difficulties of today's economic interrelationships and a changing social climate.

In 1973, Mr. Popkin retired as chief economist for the Sun Life Assurance Company and is now financial and economic consultant at Pitfield, Mackay Ross in Montreal. The author of many articles and economic studies, he wrote "Non-Merchandise Transactions Between Canada and the United States" (1963) for the Canadian-American Committee of the Private Planning Association and with W.A. MacDonald, he co-authored "Mobilizing the Resources" (1971) in response to the White Paper on Taxation.

Active in the secondary educational scene for many years, he has been President of both the Quebec Association of Protestant School Boards and the Lakeshore School Board.

Our first publication in this series of articles reprinted from other publications, covers five different points of view on levels of government involvement and responsibility in the economy. Professor H. Scott Gordon of Queen's University and the University of Indiana wrote the introductory article — *The Demand and Supply of Government: What We Want and What We Get* — for the Economic Council of Canada. Two other pieces were from the "Issues and Alternatives" series on the PROCESS OF PUBLIC DECISION-MAKING published by the Ontario Economic Council and the Federal Government's discussion paper AGENDA FOR COOPERATION. *The Role of Government: Searching for Balance,* by Judith Maxwell and *An Academic's Perspective,* by J.C. Weldon were also included.

The third booklet in this series, by David Perry of the Canadian Tax Foundation, is scheduled to be published shortly and will cover "Government Expenditures". The fourth and fifth, on other aspects of the same overall theme, will follow in the course of the fall and winter.

It is hoped that all these booklets will be useful background for the teacher who is preparing units on "The Role of Government and the Economy" — units which might be found in the economics, history, politics or social science curriculum.

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ECONOMIC STABILIZERS

Introduction

The subject matter of this economic pamphlet is a description and discussion of those economic forces and Government policy initiatives that operate to reduce the deviations of the economy from attainment of three major policy goals; maximum economic growth, full employment, and stable prices. You are probably more familiar with the use of the word "stabilizer" to describe the moveable parts of an airplane's tail to trim the aircraft toward stable level flight, or the fins attached to the sides of ocean liners to minimize the rolling and pitching of the ships in rough seas. In economics, the term stabilizer is applied to a range of automatic and policy-initiated instruments of control to keep the economy moving along a growth path that maximizes employment (minimizes unemployment) and price stability. The thrust of stabilization policy is therefore more than just ironing out fluctuations in economic activity as it is quite possible to stabilize the economy at low as well as high levels of economic activity.

In this sense the stabilizers more closely resemble the guidance system on a rocket ship which not only keeps it in a stable position around its axis, but also keeps it on a predetermined target and trajectory calculated to arrive at its goal with the maximum efficiency. This analogy cannot be pushed too far as in comparison to the precise mathematical equations fed into the rocket ship's computer that alters its movements instantaneously with highly predictable results, the data fed into the economic computer is imprecise, incomplete and often leads to results with a considerable time lag and a significant degree of variability from those predicted.

Another difficulty arises from the fact that the object of a rocket ship's mission is laid out in meticulous detail, not subject to much variation once the ship is launched. The target objective of the economy on the other hand is subject to frequent change as social, political or environmental priorities shift.

For example, an improvement in the quality of life in the form of "small is beautiful", less environmental pollution or a more equitable redistribution of income may be superimposed on the underlying aim of maximum non-inflationary growth, thus attaining the mix of stabilization policies appropriate to attaining the new economic target.

Finally, in an economy such as Canada with wide trading and financial relations with other countries, particularly the United States, the scope for Canada following through on a stabilization policy independent of developments abroad is strictly limited.

In order to properly understand the role of stabilizers in our economic system it is necessary to define what we mean by instabilitity in the system, its causes, how it is measured and why instability is something to be avoided. The discussion will then turn toward identifying the two main classes of stabilizers: the so-called automatic stabilizers that operate in the economy without any policy initiatives on the part of the Government; the discretionary stabilizers which fall under three main headings, fiscal policy or the mix of Government expenditure and taxation policies, monetary policy or the actions of the Central Bank in expanding or restricting the availability of credit and, finally, incomes policy which places statutory limits on the rate of increase in incomes and prices. The discussion will conclude with an appraisal of current problems in the application and effectiveness of traditional stabilization policy and the search for new approaches.

PART I.

THE CAUSES AND MEASUREMENT OF INSTABILITY IN THE ECONOMY

Even the most casual observer of the Canadian economy knows that it is in a constant state of fluctuation - periods of expansion or prosperity being succeeded by periods of contraction or recession. This is not a phenomenon peculiar to the Canadian economy, but is typical of all Western industrialized countries in which a significant percentage, in Canada's case around 60%, of income and expenditure decisions are made in the private sector as distinct from the government sector of the economy. The decisions of consumers to spend and save, and business men to produce and invest in new plant and equipment are all tested in the market place where correct decisions are rewarded and incorrect decisions penalized. Many theories have been advanced to explain why such an economic system is subject to recurring periods of expansion and contraction - called business cycles. They can be classified in two main categories, factors operating on the economy from outside, and factors operating internally.

External Factors include such events as wars, shifts in population, new scientific and technological discoveries. In Canada's case a particularly important external influence has been and continues to be the course of the U.S. economy. Because of the large interchange of goods and financial flows between Canada and the United States, Canadian business cycles closely parallel those in the U.S., both in timing and amplitude. This close correlation limits to a degree the extent to which Canadian stabilization policies can influence the course of the Canadian economy in a direction significantly different from that occurring in the United States.

Internal Factors, generating instability in the economy, range over a wide area of activities and theories. For a number of years following the end of World War II, the principal cause of the business cycle was laid at the doorstep of fluctuations in business inventories. The sequence of events is roughly as follows: in the early stages of a revival in business activity following a period of recession, the increase in consumer demand for goods is initially filled by running down the stock of goods on hand which had accumulated involuntarily as demand fell off in the late stages of the recession. As the advance continues, stocks of goods on hand, plus current production, become insufficient to meet current demand so production is increased and inventories are rebuilt to more efficient operating levels. As the economic expansion moves into its most buoyant final phase, individual businessmen step up both production and inventories at a faster rate than the increase in overall demand in an effort to expand their share of the markets for their particular product. In a period of relatively low interest rates or borrowing costs, and rising commodity prices, this process is intensified by the profit possibilities for business of speculative investment in inventories in the early months of expansion with the prospect of reselling at higher prices in the later stages of the expansion.

At the same time consumers have been spending at a rate faster than their increase in incomes by borrowing from banks and finance companies and also building up their own inventory of consumer goods. Eventually consumers reach a limit in their ability to borrow and consume goods at such high rates and demand falls off. Businessmen are slow to cut production levels to match falling demand,

so their inventories start to accumulate. The final phase is to fill current demands out of inventories and cut back sharply on production levels. On average this whole process occurred over a period of three to four years.

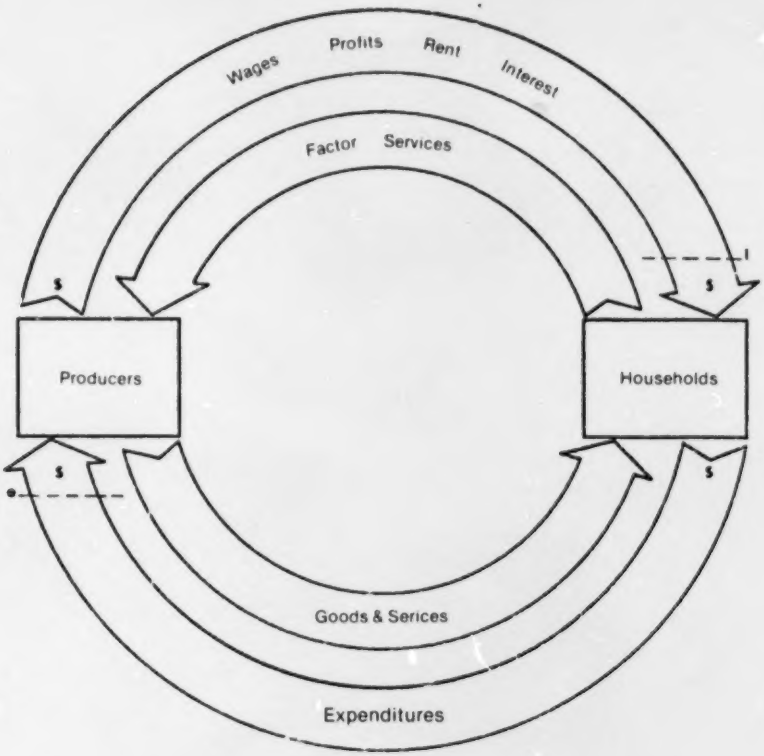
In more recent years the degree of instability arising from fluctuations in business inventories has been considerably reduced by the introduction of computer control of inventory stocks and faster communication and distribution methods which have greatly reduced the volume of inventory required by individual firms to transact a given volume of business.

In a wider sense, the greatly enlarged volume of information being collected and analyzed by sophisticated co ter techniques on all aspects of business activity such as sales volume, price trends, production rates, costs, capital expenditures and the like has given businesses a more accurate picture of the state of the economy. It has enabled them to forecast with better, though far from perfect, accuracy, prospective trends in the demand for their products and, to a degree, reduce the fluctuations in activity due to errors in assessing the outlook.

Another explanation of instability developed from the observation that in a business expansion, retail prices tend to rise faster than wages as business can quickly adjust prices upward while there is a lag in the upward adjustment of wages as wage contracts are normally fixed in advance for periods of 1 to 3 years. In more recent years with the greater sophistication of union leadership in anticipating price increases and the growing use of cost of living (COLA) clauses in labour contracts, the lag between labour income and price increases has been significantly reduced. In fact Canada in 1975 and 1976, there was considerable evidence that negotiated wage increases led rather than lagged the rate of increase in prices.

A more serious and fundamental cause of instability in our economic system arises from fluctuations in business investment in capital goods such as plant and equipment. In order to understand the crucial importance of business investment, it is necessary to explain some basic concepts about how the economy works and in particular the relationship between consumption, investment, savings and aggregate income.

Let us start with aggregate income. If we add up the market value in dollars of all goods and services produced in Canada in one year we arrive at a total which can be expressed in two ways: either as the value of all goods and services *produced* in that year, or alternatively the total flow of incomes received by Canadians in that year. For the year 1976 this total amounted to 190 billion dollars in Canada. It is important to note that the production of goods and services generates sufficient income potentially to pay for them. Money flows from households to producers of goods and services in payment for goods and services purchased. Producers on their part use the money received to buy the labour and raw material used to produce the goods and these payments become income in the hands of those offering their services and materials. This circular flow of income and spending is illustrated in the following diagram which for purposes of simplification assumes that there are only Canadian households of consumers and only Canadian producers, ignoring the foreign trade sector.



The inner circle represents the physical flow of goods and services between producers and individuals. The outer circle represents the money payments and income receipts arising out of the physical movement of goods. The lower inner circle represents the flow of goods and services, such as clothing, cosmetics, stereo records and dry cleaning from producers to households or (individuals) in exchange for dollar payments. These dollar payments to producers become their income. The upper part of the inner circle represents the flow of services in the form of labour, land and capital from individuals who own them and receive wages and salaries, rent, interest and profits in return. This flow provides individuals with the income to buy the goods and services producers want to sell. The lower circle represents the payments in dollars from individuals to producers for the things they buy. The upper outer circle represents the payments made by producers to individuals for the services they provide to producers.

In this simple illustration we have a stable economy in which sufficient income is generated and spent to buy all the goods and services produced - in other words, there is no diversion of income away from the spending stream.

In real life however consumers have the option of spending all their income or saving a portion of it. In Canada, personal savings in an average year amount to roughly 8% of after tax incomes. Saving is the temporary withdrawal of income from the spending stream for use at some later period. The money saved does not disappear out of the system but is usually placed on deposit in a savings institution.

It is thus available to be borrowed, either by other individuals who wish for example to buy homes or by businessmen who wish to build and equip new factories. Spending by individuals for housing or businessmen for factories and equipment creates an equal amount of income as any other type of spending. Thus, if this type of spending which is called investment, exactly equals the amount of saving that is occurring in the economy, the total of aggregate income will remain unchanged and the economy will remain in a stable condition. In the real world however this seldom occurs because the people who are doing the saving are not the same as the people doing the investing, and the conditions that cause people to save more or less are not the same as those that cause business to invest more or less.

For example, if the economy is approaching a recessionary phase with unemployment rising, consumers will worry about losing their jobs and will tend to spend less of their income and save more. In such a recessionary situation, however, business sales are falling and factories are producing well below capacity levels. Businessmen have little incentive to increase their spending on new plant and equipment. Under these conditions the increase in savings will not be offset by an equivalent increase in investments so that aggregate incomes and spending will fall and the economic system loses its stability and enters a declining or recessionary phase.

Eventually the decline in aggregate incomes will reduce the volume of savings to a level that matches the volume of investments that businessmen are prepared to make. The economic system will once again be in equilibrium, but at a lower level of overall incomes and spending and, as a result, at an increased level of unemployment.

There are a number of other reasons, in addition to the example given, why the level of business investment may fall short of the volume of saving. The timing of new profitable investment depends importantly on new inventions or discoveries, new technological advances, the opening of new markets, all of which happen at irregular intervals and give investment a much greater degree of volatility than the relatively stable flow of savings.

At certain times a concentration of new investment can build up to a level that exceeds the flow of domestic saving to finance and that creates excessive demand for labour and material resources, driving material prices and wages costs to higher levels. This tends to occur when large new mines, oil and gas fields, forest resources or hydro electric projects are being developed or large new public works projects, such as airports, transportation facilities, public buildings and the like are being built. Canada has experienced several such periods since World War II. Those projects were financed in part by funds borrowed from other countries, mainly the United States, to supplement the short-fall in domestic saving. Such bursts of investment generate inflationary pressures if they occur when the economy is already expanding at a rate close to its growth potential.

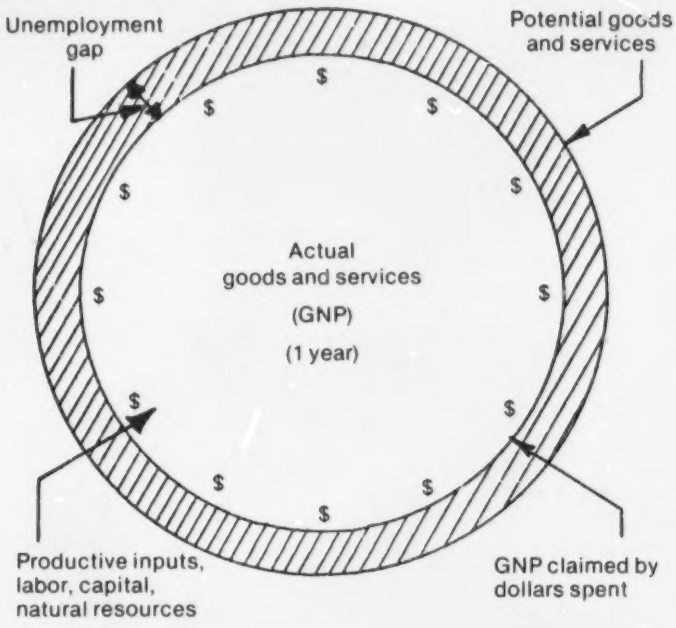
Multiplier Effect

So far we have been assuming that aggregate income will remain stable if $1.00 of investment offsets $1.00 of saving. In fact however, $1.00 of investment will increase aggregate income by more than $1.00 due to what is known as the multiplier effect. The result is that fluctuations both up and down in investment exert more

than proportional fluctuations in aggregate income. The multiplier effect works this way. Suppose for example you as a small business man, decide to build and equip a small factory to produce skis at a cost of $50,000. You engage a builder who buys the material and hires the construction labour to build the factory and you place orders for the equipment. The suppliers of the materials, labour and equipment receive as income your $50,000. They have the option of spending or saving this amount. Assuming they elect to spend two-thirds or $33,333, the suppliers of these goods if they in turn spend three quarters of their income will create income of an additional $22,222. If you continue this calculation you will find that your original $50,000 expenditure has created additional income of $150,000, or a multiplier of 3. In other words, if consumers tend to spend 2/3rds of each additional dollar of income and save 1/3, then an additional dollar of investment will result in an additional $3 of income. Similarly if consumers spend 3/4 of an additional dollar of income and save 1/4, an additional dollar of investment will result in an increase in income of $4. In a similar way, a decline of $1 in investment will decrease aggregate income by similar amounts. From this illustration you can appreciate the magnified effect fluctuations in investment have in creating instability in the level of aggregate income.

At this point we must introduce another definition of what we mean by a satisfactory degree of stabilization in our economic system. The aim of stabilization policy is not only to eliminate fluctuations in aggregate income but also to maintain aggregate income at a level that fully employs Canada's resources of labour and industrial capacity; in other words, to keep the economy operating at its potential. This potential is determined from year to year by two factors: the number of workers in the labour force and the volume of goods and services produced by each member of the labour force, or, worker productivity. Based on these factors, Canada has the potential to increase the volume of goods and services produced over the next five years or so at an annual rate of around 5%. This is roughly the rate of increase that was actually achieved in 1976. In 1975 however, the economy expanded by only 0.6%; well below potential. Unemployment increased from 5.4% in 1974 to 6.9% in 1975. The following diagram illustrates the relationship between the economy's potential to produce goods and services, and the unemployment gap that develops when the actual volume of goods and services produced falls below potential.

THE ECONOMIC PIE


Unemployment gap
Potential goods and services
Actual goods and services (GNP) (1 year)
Productive inputs, labor, capital, natural resources
GNP claimed by dollars spent

The outer ring represents the amount of goods and services that the economy is capable of producing in a particular year given the size and productivity of its labour force. The inner ring represents the value of goods and services actually produced during the year. The striped area of the pie represents the amount by which actual production falls below potential production* and depicts the resulting underutilization of labour resources or unemployment.

Despite the Canadian economy expanding close to its average yearly potential rate in 1976, unemployment increased to 7.2%. This indicated that the amount of slack in the economy in the form of unemployed workers plus students entering the labour force for the first time, was large enough to allow the economy to expand at a faster rate than yearly increases in the labour force and productivity would permit. Such a condition of underutilization of resources is called - the *unemployment gap.*

When, as has already been suggested, investment increases at a rate faster than savings at a time when the economy is operating close to, or at, its potential for producing goods and services, the magnified increase in income is absorbed by bidding up the price of available goods and services and we have an inflationary situation. Instead of an unemployment or deflationary gap, we have an inflationary gap. This gap is self-reinforcing in the sense that higher prices for investment goods result in a multiple increase in incomes to the suppliers of those goods. The process stops when the cost of producing consumer goods at a profit from the high cost new investment exceeds the ability or willingness of consumers to buy the higher priced goods.

* called the GNP gap

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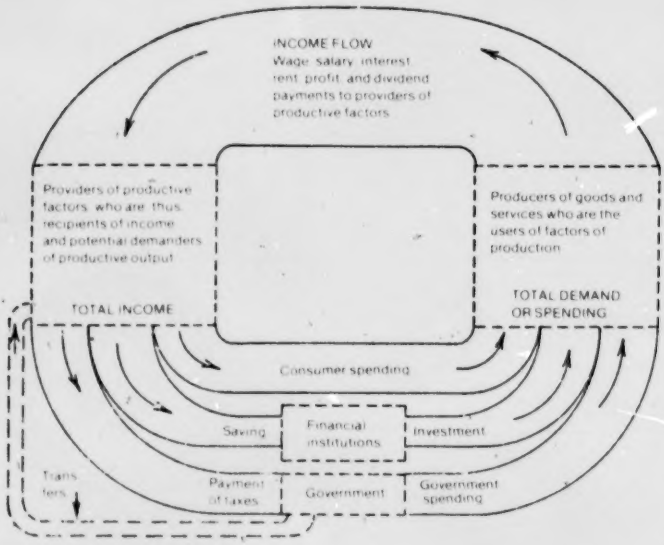
Up to this point we have assumed, in our simplified description of the economy, that there were only producers and consumers in the private or non-government sector of the economy. In real life we know that there are two other important institutions whose operations can have a tremendous influence on the stability or otherwise of aggregate income. The are (1) Government bodies, Federal and Provincial and (2) the Bank of Canada. They are key actors, both in causing instability in the economy at times and in stabilizing the economy at other times. Our immediate interest is in examing the ways in which their activities may increase instability in the economy.

The Role of Government

THE FLOW OF INCOME AND SPENDING


INCOME FLOW
Wage, salary, interest, rent, profit, and dividend payments to providers of productive factors
Providers of productive factors, who are, thus, recipients of income and potential demanders of productive output
Producers of goods and services who are the users of factors of production
TOTAL INCOME
TOTAL DEMAND OR SPENDING
Consumer spending
Saving
Financial institutions
Investment
Trans fers
Payment of taxes
Government
Government spending

In figure 3 we have expanded our circular income flow model to include the activities of governmental bodies as spenders and distributors of incomes. Governments obtain the cash to pay for their expenditures largely by levying taxes on individuals and business. To the extent government expenditures are fully financed by taxes, the leakage from the private spending stream represented by government taxes is offset by the increase in government spending.

The potential for government spending and taxing activities to generate instability in the economy derives from several sources.

a) A rate of increased spending persistently greater than that of G.N.P. illustrates the rapid increase in government spending in the post-war period. Government spending has persistently increased at a faster pace than the economy as a whole. When the economy has been expanding at a rate close to potential, the increased volume of government spending has diverted scarce manpower and material resources from the private sector where productivity gains tend to be larger to the government sector where such gains are small. This results in an increase in incomes greater than the increase in the volume of goods and services and is therefore inflationary. This effect occurs even if government spending is fully financed by diverting incomes from persons or business to fully finance the expenditures. The lower productivity in the government sector arises from the fact that many of its activities such as social services, inspection services, education, police, medical care, are not open to the application of technological improvement such as automation to the same extent as the production of goods. Productivity increases lower the cost of production and prices. Therefore if wages in the government and private sector are equalized, the price of government services and therefore their expenditures will rise faster than those in the private sector because of higher productivity increases in the private sector.

b) As a larger and larger share of a country's economic activity comes under the direct control of governments, an increased degree of instability is introduced from two sources:

i) Government ministers and their civil service advisers become overwhelmed by the sheer weight and complexity of the hundreds of decisions they are called upon to make daily, often under severe time limitations. Increasingly these decisions are made in terms of short run solutions to problems which are essentially long term in nature and which are aggravated rather than solved by short run solutions. For example a Canadian industry may find the Canadian market for its products being seriously reduced by an influx of cheaper products from a foreign country. Under pressure of that threat of rising unemployment in the industry a short run solution is found in restricting the volume of imports of that product. The long run problem of the industry however may be that its competitive position has been fundamentally weakened by rising costs. The proper long run solution may be to gradually phase the industry out and transfer the resources into more competitive areas. When the Government becomes overloaded with pressing problems and decisions, the short run solution which leads to longer run instability is more likely to be the one taken.

ii) A second source of government instability arises from the fact that decisions made by the government are big decisions in that they affect whole industries or large groups of consumers or producers.

As government ministers or administrators are human and not omniscient, they make their share of mistakes and when they do they tend to be lulus. Decisions in the private sector are made by thousands of individual consumers and producers and while they also make mistakes, they are not all in the same direction so a lot of them cancel each other out.

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The tendency of governments to grow bigger and bigger is partially the result of increasing demand for government services due to the shift of population toward the cities and large expenditures for streets, sewers, public buildings, public demand for social services, increasing concern with pollution, a greater need for improved communication and transportation systems.* Another reason is the progressive personal tax system which funnels an increasing percentage of rising incomes into government hands in the form of taxes. A progressive tax system is one in which the *rate* of tax increases with the size of income. The personal tax system in Canada is progressive in this sense. (See later text)

Canadians have enjoyed a rising level of income over the years and personal tax revenues of the government have increased at an even faster rate. Taxes as a percentage of personal incomes have increased over the years as follows:

1955	8.7%
1965	10.8%
1970	17.3%
1975	19.3%

The big jump over the past ten years reflects in large part the effects of inflation in accelerating increases in personal incomes and therefore tax revenues. Increased tax revenues in the hands of the governments are like cash in your pocket - easy to spend. If the cash is not needed for current programs new programs will be created.

Inflation

In recent years high rates of inflation have been one of the major sources and effects of instability, not only in Canada but in virtually all Western economies. A period of inflation can be defined as a time of generally rising prices, and the most simplified explanation is too much money chasing too few goods. What is implied in this statement is that by some means extra money or purchasing power has been introduced into our circular income flow diagram over and above that paid to labour and suppliers of material. If this extra money is injected into an economic system that is working to capacity i.e. full employment and plant utilization, this extra purchasing power cannot buy more goods or services. It will be used to bid up the price of goods already in the market to a level where all the extra money will be required to clear the market of available goods. If the extra money is not a one shot increase but rather a continuous flow, a persistent rise in prices will be set in motion. Most economists call this process "demand-pull" inflation since the extra money creates the increased demand for goods that pull up prices.

A later inflationary stage occurs when workers react to higher prices or, more importantly, to the expectation of higher prices, by demanding higher wages. If such workers are unionized, or their skills are in great demand, they will be in a position to get such wage increases. The firms that employ them will try to offset these extra wage costs and protect their profit margins by raising prices, and in a buoyant economy, or if they are in a monopoly, or near monopoly position in marketing their products, they will be successful. This inflationary process is called "cost-push" inflation as higher costs push up prices.

* See "Understanding Urban Development in Canada, Canadian Foundation for Economic Education, 1977

Two major questions about inflation require an answer! Why is it bad and how does the process get started? Theoretically if all prices and net incomes from whatever sources, grew at the same rate and maintained the same relationship to each other during the rise, inflation would not introduce instability into the economic system. In fact however great inequalities in the incidence of prices, costs and incomes increases occur in an inflationary period which, if allowed to continue unchecked, would destroy the economic system.

A few examples illustrate this effect. People living on fixed incomes, either pensions or investment income from bonds or mortgages, see the purchasing power of their incomes decline as prices rise; prices rise faster than wages for non-unionized workers, and at the same time government taxes take a larger bite out of rising wages due to the progressive tax system; cash generation by business is hurt by government taxing of inflated inventory profits and by the growing inadequacy of tax-allowed depreciation on old plant and equipment to finance new higher priced replacements. In addition, inflation increases interest rates as lenders demand higher rates to compensate for the falling purchasing power of the dollar. Higher interest rates discourage business borrowing to finance new plants and equipment, depressing the level of economic activity. Inflation shifts income from the private to the government sector because of the progressive tax system and creates the instability already referred to when the government sector grows faster than GNP. Above all, inflation creates uncertainty about the future in the minds of consumers and business people.

In short, inflation is bad because it distorts the flow of income between various classes of recipients, between savers and investors, between costs and prices and impedes normal growth by creating uncertainty about the future. The other principal question to be answered is how does it get started?

Historically, the initiation of periods of inflation were usually identified with war periods, or periods of large new gold discoveries. Wars are inflationary because production is shifted from consumer goods to armaments so that the large incomes earned by an economy producing at capacity enter a market in which the volume of consumer goods is rapidly declining. As a result prices are bid up. When the amount of money was directly related to the volume of gold reserves, large new gold discoveries greatly expanded the volume of money without a corresponding increase in the volume of new goods and services that could be purchased.

As a consequence, the price of available goods rose to absorb the extra purchasing power. The inflation that the world has experienced in recent years cannot be attributed directly to war or gold discoveries, and its cause is still the subject of controversial debate among economists. The main cause is still the same - that is too much money chasing too few goods. The key question is how did too much money get into the system? If we substitute the phrase "too much money" for "too much demand" remembering that in our economy you need money to be an effective demander in the market place, we broaden the definition of inflation to that condition in which individuals, business and governments demand more goods and services from the economic system than it is capable of producing in a given time period and, somehow, obtain sufficient money from the system to make these demands effective in the market place.

While there appear to be two questions arising out of this definition - why consumers demand more than the economy can deliver and how they get the money to make their demands effective - the crucial question is the supply of money. In an economic sense, consumer wants are virtually limitless. If a consumer's imagination

falters in creating new wants, imaginative investors and advertising executives fill the gap with a bewildering array of new products and services. Yesterday's luxuries become today's necessities. As living standards rise, the trend is reinforced by the pressure of rising expectations. Everyone, irrespective of income level, not only wishes but comes to demand a standard of living comparable to that of the majority. Improved communications through radio and television and increased movement of people, both within and outside the country, have broadened people's knowledge of and desire for higher living standards.

On the money side, the gap between earned income and desired spending levels was narrowed in the first instance by large increases in borrowing, by consumers, business and governments. To the extent funds are borrowed from individuals who have elected to save rather than spend, the necessity to repay the borrowing over a specified time period means that while there is a short term increase in purchasing power, there has not been a permanent increase in the money supply that would raise the level of prices over any extended period. However, there is a mechanism through the banking system whereby the money supply can be increased over long periods and which can fuel a persistent increase in prices, i.e. inflation. The banking system consists of the privately owned chartered banks and the publicly controlled central bank, the Bank of Canada.

Let us look first at the ability of the chartered banks to create credit or money.

Money Creation by a Single Bank

A new bank in your community opens its doors and you, as the first customer, deposit $1000 that you earned during the summer. In the bank's double-entry bookkeeping system, your deposit is a liability and the cash you deposited is an asset. To attract your deposit, the bank has agreed to pay you interest. In order to do so the bank must itself acquire an asset that earns interest. Since the cash you deposited doesn't earn interest sitting in a bank account, the bank will use most of your cash to buy a bond or make a loan to another person or a business. In doing so it assumes the risk that you will not withdraw all, or a major part, of your deposit from the bank in the immediate future. Bankers know from experience that, given thousands of depositors, it is safe to invest or loan most of depositors' cash or, in other words, hold cash reserves equivalent to some small percentage of deposits. In this case the bank's balance sheet might look like this:

Bank A

ASSETS		LIABILITIES	
Cash Reserves	$ 60	Deposits	$1,000
Loans & investments	$ 940		
	$1,000		$1,000

In Canada, banks are required by law to hold a minimum cash reserve of about 6% of deposits (4% of savings deposits, 12% of demand deposits). The cash Bank A paid out to buy the investment, or make the loan, will end up in some other

bank (Bank B) as a deposit in the name of the person who sold the investment to Bank A or who received the loan. As deposits are part of the money supply, Bank A has increased the money supply by $940 in the form of deposits in Bank B. Bank B balance sheet will look like this:

Bank B

ASSETS		LIABILITIES	
Reserves	$ 56.40	Deposits	$940.00
Loans & investments	$883.60		
	$940.00		$940.00

Bank B in turn will hold only 6% of its increase in deposits, i.e. $56.40 as a reserve and invest or loan the balance - let us assume to depositors in Bank C and so, to Banks D, E, F, etc. If you continue this calculation you will find that your original $1000 cash deposit has multiplied to $16,666 comprising $1,000 in cash reserves and $15,666 in loans and investments. In the real world things do not work out so smoothly as some deposits may be withdrawn from the banking system altogether and hoarded, or some banks may not choose to run their reserves down as low as 6%. Nevertheless the banking system as a whole can increase in a ratio of about 16-2/3:1 whatever amount of cash reserves is permanently left with it or, in other words, create 16-2/3 dollars of new money for every $1 of deposits it receives.

It is important to note that the creation of new money by the banking system is not an *automatic* process; three conditions are necessary. The public must be willing to leave its money on deposit in the banks, thus providing the banks with additional reserves; the banks must be willing to make loans or investments with their excess reserves i.e., cash reserves larger than 6% of their deposits and the public must be willing to borrow from the banks or sell securities to them.

While it is perfectly feasible for a country to operate without the assistance of a Central Bank, and indeed Canada did so until 1934, the de-stabilizing effect on the economy of large fluctuations up or down in the money supply, in particular the large deflationary decline in aggregate incomes that occurred during the great depression of the early nineteen thirties, prompted the government to set up a bankers' bank that would regulate the supply of money so as to even out fluctuations in the economy. In the preamble to the Bank of Canada Act the functions of the bank are described this way -

> "to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuation in the general level of production, trade prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of the Dominion".

From the outset, the role of the Bank of Canada was to act as an economic and financial stabilizer in the economy. At times, Bank of Canada policy has aggravated rather than mitigated de-stabilizing trends in the economy by wrong diagnosis of the economic situation or poor timing of stabilizing efforts. The techniques the Bank uses to regulate the money supply, or failure in carrying out its mandate, will be discussed in a later section of Part II.

Summary Part I.

In Part I we have discussed the many sources of instability in the Canadian economy. In particular it has been noted that -

1. Instability is measured primarily in fluctuations in aggregate income or GNP.
2. Industrial economies in which a large portion of economic activity is transacted in the private market place are subjected to rythmic fluctuations of three or four years duration.
3. Business inventory management or mismanagement has been an important contributor to cyclical fluctuations in the economy. In more recent years, rising costs and reduced availability of energy, raw materials, efficient industrial plant capacity and credit have put a limit on the ability of the economy to grow at its potential rate without generating strong de-stabilizing inflationary pressures.
4. The tendency of business capital investment to accelerate to high levels toward the end of the business cycle, on the one hand, or to lag well behind demand requirements due to economic uncertainty on the other, has been a source of instability in the economy.
5. The increasing role of government in the economy, as measured by a rise in its expenditures toward 50% of GNP, has introduced an additional source of instability by overloading the economy. By absorbing an accelerating share of available skilled manpower, goods and financial resources, it has restricted the ability of the private sector to remain competitive and expand sufficiently to provide jobs for a fast growing labour force.
6. Finally the strength of inflationary pressures in the industrial world, including Canada, in the 1970s has provided the greatest challenge to the stability of the economies of the Western World since the great depression of the 1930s.
7. It is against this background of both short and long term sources of instability in our economic system that instruments of stabilization policy both automatic and policy directed will be discussed in Part II.

THE STABILIZERS PART II

The term stabilizer is used to describe those economic and financial trends or techniques that, either automatically or by policy initiatives, iron out rhythmic fluctuations in the economy and propel it along a growth path that maximizes employment and price stability. For discussion purposes, stabilizers can be classified as automatic or discretionary. Automatic stabilizers come into operation without anyone taking specific action; discretionary stabilizers require someone to make a specific decision about their use before they can come into operation. A further classification can be made between those automatic and discretionary stabilizers that operate in the private and public sectors of the economy.

PRIVATE SECTOR STABILIZERS

In the private sector the distinction between automatic and discretionary stabilizers is not as clear cut as in the public sector. Stabilizers that might be termed automatic in the sense that consumer habits and attitudes in the past have consistently led to a stabilizing effect on the economy, can lose their automatic feature if consumer attitudes change. For example, the fact that wages and salaries tended to fall behind the rate of price increase when the economy expands rapidly and similarly to fall behind the rate of decline in prices in a period of recession, has for years been regarded as an automatic response tending to dampen the range of economic fluctuations. In the strong inflationary period of the past two or three years, labour was successful in not only eliminating the lag between wage and price increases but in a number of instances obtaining wage increases larger than the increase in prices. Thus the growing sophistication and power of union leadership has interrupted the automatic stabilizing effect of the lagged response of wages to price increases or decreases.

Other trends in consumer and business behavior that have tended to dampen fluctuations in the economy include the following:

1. *Consumers alter their spending patterns slowly in response to decreases or increases in their incomes.* Faced with declining incomes, consumers' spending will decline more slowly than their incomes as they use up their savings or borrow to maintain their standard of living. Similarly a sudden increase in incomes will not be reflected immediately in a similar increase in expenditures. These delayed responses dampen the volatility and amplitude of economic fluctuations.

2. The fact that consumers are able to stabilize their costs over a one to three year or longer period for a number of important items is a stabilizing factor in a period of rising prices. Such items are mortgage payments or rent on a house and payments for automobiles, larger household appliances and insurance.

3. In the business world certain administrative procedures have been adopted that automatically dampen the volatility of the business cycle. An important one has been the use of computerized data to control the management of inventories. This has both reduced the volume of inventories required to transact a given volume of business and ensured a more efficient match of

the types of goods carried in inventory to current sales. Once such a system is set up it operates automatically. This has significantly reduced the level of instability created by poor inventory control which was referred to in Part I.

4. The business practice of hoarding labour in a period of declining business tends to stabilize personal incomes in a recession. By hoarding labour is meant the reluctance of business to lay off its skilled workers and professional employees in a period of temporarily slack business, both for reasons of loyalty and the difficulty of finding equally qualified replacements when business improves.

5. The practice of companies maintaining a relatively stable level of dividend payments in comparison to wide yearly fluctuations in profits acts to stabilize the investment income flow to shareholders.

6. The increasing tendency of large and medium sized businesses to plan their operations and particularly their capital investment programs over a five year time period rather than on a year to year basis. This has helped to even out the lumpiness in capital investment that in the past has been an important destabilizing influence in the economy as was noted earlier. The full stabilizing benefits of such planning have been watered down in recent years by the increasing level of uncertainty about the business outlook, generated not only by world wide inflationary trends, but also by greater government involvement in the business sector and frequent changes in government rules, administrative and tax, within which Canadian business must operate. Advance planning, to be effective, must operate in a climate of relative certainty of the structure of governmental regulation in which it will be operating over the forecast period. This relative certainty has not been a feature of the Canadian economy for a number of years. This brings us to a discussion of the automatic and discretionary stabilizers that operate in the public sector which are, in fact, more powerful and effective than those operating in the private sector.

PUBLIC SECTOR STABILIZERS

Automatic Stabilizers

Perhaps the most important automatic stabilizers in the public sector are those that automatically regulate the level of government revenues and expenditures during periods of business expansion and recession. On the revenue side, the principal regulator is the progressive personal tax system. A glance at the Federal Government's personal tax schedule for 1977 will illustrate this feature.

1977 Rates of Federal Income Tax
(Before provision for provincial taxes)

Taxable Income	Tax	
$ 710 or less	6%	
710	$ 43 + 16% on the next	$ 709
1,419	156 + 17% on the next	1,419
2,838	397 + 18% on the next	1,419
4,257	653 + 19% on the next	2,838
7,095	1,192 + 21% on the next	2,838
9,933	1,788 + 23% on the next	2,838
12,771	2,441 + 25% on the next	2,838
15,609	3,150 + 28% on the next	4,257
19,866	4,342 + 32% on the next	14,190
34,056	8,883 + 36% on the next	21,285
55,341	16,546 + 39% on the next	29,799
85,140	28, 167 + 43% on the remainder	

Taxes increase from 11.86% for an individual with a net income of $5,000 or a tax of $593.00 (after the $200 Federal tax reduction) to 28.24% for a net income of $50,000 or a tax of $14,121.00 (after the $500 Federal tax reduction). While the increase in net income from $5,000 to $50,000 is 10 times, the net increase in tax is 24 times. It is estimated that this leverage factor (multiplier effect) of the current tax schedule is such that a 10% increase in taxable personal income yields 14% increase in Federal Government revenues. The leverage factor also works in reverse for a decline in taxable income. The rationale of a progressive tax system is that taxes should bear a relationship to an ability to pay.

The effect of the system is to move the Federal Government's Budget, or balance between revenues and expenditures, to a surplus position during a boom period, thus draining purchasing power away from consumers and slowing down the pace of business activity. Conversely in a period of recession, government revenues drop faster than the decline in government expenditures and the resulting deficit cushions the decline in personal incomes. Thus without any change in government policy, the leveraged rise in government revenues during boom periods and fall in recession periods reduces the fluctuations up and down in personal incomes that would otherwise occur under a system of a flat rate tax system.

In an inflationary period such as we have recently experienced, with yearly increases in wages rising as high as 15% or 20%, the government realized extremely large increases in revenue at a time when consumers needed the increased income to pay the inflated prices for consumer goods. In 1974, the government recognized this problem by reducing the increase in each tax bill by the percentage that consumer prices increased in the twelve months ending in October of the year before the tax was levied. This ensured that the government would not get a revenue bonus as a

result of inflation. Even after this adjustment however there is still some leverage, or what is sometimes called fiscal dividend left in the tax system. For the year 1977 it is estimated that personal income taxes will be lowered by roughly $1 billion as a result of applying the inflation reduction factor.

On the expenditure side of the government's budget an important automatic form of stabilization occurs in connection with the government's unemployment insurance plan. Under the terms of the unemployment insurance act, the government levies a special tax on employers and employees and pays a monthly income to all those who are unemployed. While the conditions under which such payments are made vary from time to time, unemployment income premiums and benefits are an integral part of our fiscal system. In 1976 unemployment payments totalled $3.4 billion.

Another form of income stabilization is the system of family allowances under which monthly payments are paid to parents, based on the number of children in the family, and, in some provinces, on a sliding scale according to age. These payments do not vary inversely or in conjunction with GNP. Nevertheless they provide some increased stability to the income stream. A broad system of welfare benefit payments is also in operation, payments being made to persons that for various reasons are unemployable or whose earning power falls below a minimum sustenance level. While such payments are not strictly automatic in that some proof of need is required, such a system can be regarded as a permanent feature of a modern economic democracy, though the level of benefit payments will vary with circumstances..

Discretionary Fiscal Stabilizers

Important as are the automatic fiscal stabilizers described in the preceding section, there are periods of prolonged rising activity in the economy, or stagnant to declining activity, when the automatic stabilizers fail to cool out a boom, or revive an economy floundering along in a recession. Or even more importantly, the automatic stabilizers may be effective enough to stabilize the economy but at a level of activity that is well below that necessary to employ fully all available resources.

We discussed in an earlier section how such a deflationary gap could occur. Under such conditions, the government must assume a more active policy-directed stabilization role. The criteria the government uses to determine the major thrust of its policy intervention - toward stimulation or restraint - include such items as trends in unemployment, inflation, capital investment and the balance of international trade.*

Public Sector Discretionary Stabilizers

Government stabilization policy in Canada has traditionally been carried out by the Federal Government in spite of the fact that provincial and municipal government expenditures exceed federal expenditures. This has meant that the effectiveness of Federal Government stabilization policies has increasingly depended on the cooperation of the provinces.

The Federal Government carries out its stabilization role chiefly through its ability to vary the balance between its revenues and expenditures, to produce in any year a budgetary deficit or surplus. The government also has access to administrative regulations outside the budget making process to help stabilize the economy or certain sectors of it. Examples of such regulatory tools include price and wage guidelines, commodity marketing Boards which regulate the supply and prices of certain commodities and guidelines for foreign investment in Canada

* See "Understanding Canada's International Trade Policy", Canadian Foundation for Economic Education, 1977

Fiscal Budgetary Stabilization Policy

A budgetary deficit is stimulating to the economy in varying degrees, depending on the particular mix of tax relief or increased expenditures that create the deficit. It also depends on how the deficit is financed. If it is financed by selling government bonds to the public so that there is no increase in the money supply (although there maybe a stimulating increase in the velocity of money) the stimulus is less than if it is financed by selling bonds to the Bank of Canada which does involve an increase in the money supply. (The role of the Bank of Canada monetary policy as a stabilizer is discussed in a later section.) In the same way a budgetary surplus slows down the rate of activity in the economy. In carrying out its stabilization role the Federal Government is faced with two types of questions. First - should the thrust of its fiscal policy be toward stimulation (budgetary deficit) or restraint (budgetary surplus); second - having decided that, what is the best mix of tax and expenditure policies to adopt to achieve the correct amount of stimulation or restraint on various sectors of the economy?

These decisions have always been difficult ones due to imperfect knowledge of the real state of the economy at any particular time and of the impact and time lag between the change in tax or expenditure policy and its effect on the economy. For example, if a downturn in activity is judged to be a temporary build-up of production in excess of current demand, some tax relief on personal incomes might be all that is required to stabilize the economy. If however the sluggishness is rooted in a low and declining volume of capital investment, a broader range of fiscal stimulants might be appropriate, including corporate tax relief and tax incentives for increased saving to facilitate the financing of new capital projects. The complexity of choosing the correct fiscal stabilization policy is well illustrated by the dilemma facing Finance Minister Macdonald in preparing his budget in the spring of 1977. The economic environment at that time included the following features:

1. A sluggish economy entering a year of real growth estimated at 3-4%, well below its 5% potential rate and against the background of an unemployment rate at a relatively high 7-1/2%, an industrial sector operating at only 80% of capacity, and an inflation rate, although declining, still at a relatively high rate of 7-1/2%.

2. A flat to declining volume of business capital investment as a result of sluggish overall demand, high construction and equipment costs, a level of corporate earnings insufficient to encourage corporate investment in new plant or equipment or to finance a major share of such investment, and finally a pervading mood of uncertainty about the direction of future government policy regarding wage and price controls, Federal and Provincial trends toward nationalizing private industries and the future of Quebec.

3. A persistent large deficit - $4-1/2 - $5 billion in Canada's external balance of payments (the excess of imports of goods and services over exports of goods and services). While the overall trade balance in goods had moved into a surplus position, deficits were continuing to increase in manufactured goods where cost of production and prices were higher than in other countries; in interest payments on funds borrowed in other countries; in energy, and in the travel account, as Canadian tourists spent more money abroad than foreign tourists spent in Canada.

4. A Federal Government committed to holding the growth in government expenditures in line with the growth in GNP following a number of years in which such expenditures exeeded GNP growth by a significant amount.

The slow rate of prospective growth in the economy in 1977 together with high unemployment and unused plant capacity clearly indicated the need for some fiscal stimulation. The next question was should it be introduced by an increase in spending or a cut in taxes. The argument against an increase in expenditures was that it would violate the government's commitment to hold spending to the growth in GNP. This did not allow any leeway for an overall increase in spending.

However, the high level of unemployment among young people and in certain regions of the country argued strongly for a specific program of job creation and training, the cost of which, by appropriate cuts in less essential programs, could be absorbed without violating the GNP growth target. The main thrust of fiscal stimulation thus fell on appropriate tax cuts.

The problem here was to introduce the necessary degree of stimulation without strengthening inflationary trends. A cut in personal income taxes, concentrated in the middle and lower income groups would have the advantage of a fairly quick response in increasing consumer demand for goods and services - thereby stimulating some revival in business capital spending to meet the increased demand. The drawback to this approach was: 1 - the flow of incomes to consumers was already strong; 2 - the sluggishness in consumer spending in the domestic market was due to the high proportion of consumers' incomes in savings. And 3 - the large percentage of personal income spent on imported goods which were relatively cheaper than domestic products. To the extent consumers saved or bought imported goods with their extra income, the inflationary impact of the increase in personal income would be minimized, but so also would be the immediate stimulating effect on the economy.

An alternative form of tax cut which would minimize both the leakage of income from the spending stream by way of savings and imports, and would have the effect of reducing rather than raising prices, would be a cut in the Federal Government's sales tax and cuts in provincial retail sales taxes. Cuts in retail sales taxes have the added advantage of reducing prices for a number of goods that enter into the consumer price index. As an increasing number of wage contracts tie wage increases to increases in the consumer price index, the reduction in prices brought about by a cut in the retail sales tax might help moderate future wage demands. One drawback to using retail sales tax cuts is that they are imposed by the Provinces, and their reduction would require cooperation by the Provinces.

The sluggish pace of business capital investment and the desirability of stimulating such investments in order to increase production efficiency, reduce costs and increase competitiveness argued strongly for some special stimulus for the business sector. The government had several options to stimulate investment. It could reduce the tax rate on corporate profits, currently 46%, to allow corporations to retain a greater share of earnings to finance new capital expenditures. However as this tax benefit would be received by all corporations, irrespective of whether they increased capital expenditures or not, it would be an indirect and uncertain form of stimulation. A direct form is accelerated depreciation whereby a corporation deducts the cost of new plants and equipment from its income, over a shorter than normal period. Canada has such a tax provision, covering the manufacturing and processing industry, to allow for such a write-off over a two year period. Another form of direct stimulation is the investment tax credit which allows a corporation to deduct an added percentage (above normal depreciation rates) of the cost of new plant and equipment. Such a tax credit amounting to 10% is currently in use in the United States for machinery and equipment expenditures.

An important tool of Federal Government stabilization policy has been the stimulation or restraint of residential construction. The housing industry has been important as a stabilization tool, particularly as a stimulant, for it employs a lot of labour and thus has a direct impact on unemployment. It happens over every section

of the country, and it promotes the desirable objective of upgrading the living standards of a majority of the population. The government has stimulated housing construction in a number of ways: it provides funds directly to the Central Morgage and Housing Corporation to lend to low income home buyers at mortgage rates below the market level; it guarantees lenders of mortgages issued under the National Housing Act against default by the home buyer up to 95% of the amount of the mortgage; it provides mortgage money at lower than market rates to contractors building apartment buildings, on condition they agree not to raise rents on such apartments for a certain period.

As with any tools of stabilization policy, there are limits to the use of home building as a stimulant set by the overall need for additional housing and the priority in the use of materials, labour and savings. In the situation facing the Finance Minister in preparing his Spring Budget, it could be argued that, following two years of home building well above the annual figure of 250,000 housing starts set as a target objective by the government until 1980, the use of home building in a stabilization policy should be limited to ensuring that housing starts do not fall below a level that would produce a downward drag on the economy. This would suggest a minimum volume of 230,00 starts in 1977, compared to 270,000 in 1976.

Discretionary Government Administrative Stabilizers

There are times when distortions in the normal functioning of the economy create such a degree of instability that the Government feels compelled to supplement its automatic stabilization tools with more direct intervention into the decisions made by consumers, workers and businessmen. In Canada, the need for quite extensive administrative intervention occurred during the period of the two World Wars in 1914-18 and 1939-45. In World War II in particular the need to shift the economy's production resources in a hurry from consumer to military goods forced the government to impose a complex system of wage and price controls, including rationing of scarce consumer commodities. The purpose was not only to see that scarce goods were distributed fairly, but to ensure that the inflationary effects of the large flow of personal and corporate income, earned in the production of military goods and not consumed, was not used in bidding up the prices of the dwindling volume of consumer goods that were available.

Prior to recent experience, the propulsion of a degree of inflation sufficient to justify the imposition of general wage and price controls was thought to be exclusively a war-time phenomenon. However, during the late 1960s and early 1970s it became apparent that strong inflationary trends were gripping all the major industrial countries as governments and consumers of these countries were demanding and receiving the income, in one form or another, to bid for a larger amount of goods and services than the capacity of their economies could supply. Once such an inflationary trend becomes established, it is reinforced by the expectations of consumers, wage earners and business people for ever increasing prices. Consumers buy in advance of their real needs to protect themselves from next year's expected higher prices; businessmen start accumulating excess inventories to avoid higher future costs or to make a speculative profit.

The normal stabilization tools of an anti-inflationary policy are a restrictive monetary and fiscal policy by which the growth of aggregate income and therefore total demand on the economy is reduced. It could also be argued that increasing the supply of goods and services to absorb the increase in income would also be an effective anti-inflation stabilization tool. The trouble with this approach is that the economy is likely to be operating close to capacity levels at the height of the inflation, so that increasing supply depends on expanding industrial capacity which takes a long time.

In a later section we will discuss the failure of the Canadian Government to follow an appropriately restrictive monetary policy during the recent period until inflation had got out of hand. The government's preoccupation with extending and broadening the social welfare base of the economy, which by itself was a perfectly laudable and legitimate course of action, was inappropriate in its extent and timing in the strongly inflationary environment that prevailed. In fact, in conjunction with very large wage increases granted to employees in the public sector, this was a major contribution to the crisis level of high price and wage increases that developed during 1975, with prices rising at an annual rate of 10.8% and wages by 13.3%.

In these circumstances, in October 1975, the government imposed a system of compulsory wage and price controls. The use of compulsory wage and price controls in other than a total war economy, remains a highly controversial topic. The principal arguments pro and con can be summarized briefly as follows:

Arguments for Control:

1. Following a prolonged period of strongly rising prices due to excessive demand, reinforced by rapid increases in wages as workers seek to protect their incomes not only from current, but also prospective increases in prices, the degree of monetary and fiscal restraints necessary to lower consumer, business and worker expectations about future price increases would throw the economy into a severe and prolonged recession. It is thus argued that a two or three year program of controls, aimed at forcing graduated reductions in the rate of increase of both prices and wages, would reduce the inflationary expections without creating a severe depression.

2. An argument for controls has been made on the basis that the market system of supply and demand no longer works effectively to determine prices or wages. On the price side, it is arg ed that large corporations dominate the supply and pricing decisions for an ever-increasing volume of consumer and industrial goods and that they have the power to raise prices with no relation to costs. On the wage side, it is argued that unions have gained increasing monopoly power over wage demands. This fact together with the extension of the right to strike to government employees where excessively large increases are paid for by the public and are not restrained by the danger of forcing the employer into bankruptcy, as might occur for a private company, means that the traditional restraints of rising unemployment on the size of wage demands no longer operate effectively.

Arguments Against Controls:

1. The main argument against the use of controls is that their effectiveness in dampening price and wage increases is poor and is won at a high cost to the economy in terms of distortions in the distribution of income, disincentives to the expansion of business and the generation of a climate of social unrest.

2. Under the best of conditions a price and wage control program is only effective for a relatively short period - say one to three years. By lowering inflationary expectations, such a program is expected to provide the economy with a breathing spell during which more effective anti-inflationary policies of fiscal and monetary restraint can work gradually to bring demand in better alignment with supply. One problem is that once governments have adopted controls they have tended to use the breathing spell to merely breathe easier, rather than reduce overall demand by cutting back their own expenditures and following a more restrictive money supply policy.

3. Embarking on a policy of price and wage controls has been likened to grabbing a tiger by the tail. It is difficult to let go without being bitten or mauled. In other words, when controls are lifted, there is a strong urge by workers who have felt hard done by from wage controls and businessmen who have seen their profits shrink or disappear under controls to try quickly to recover these losses, real or imagined. Thus the gains against inflation painfully won over a one or two year period, can be lost in the first six months of the decontrol period.

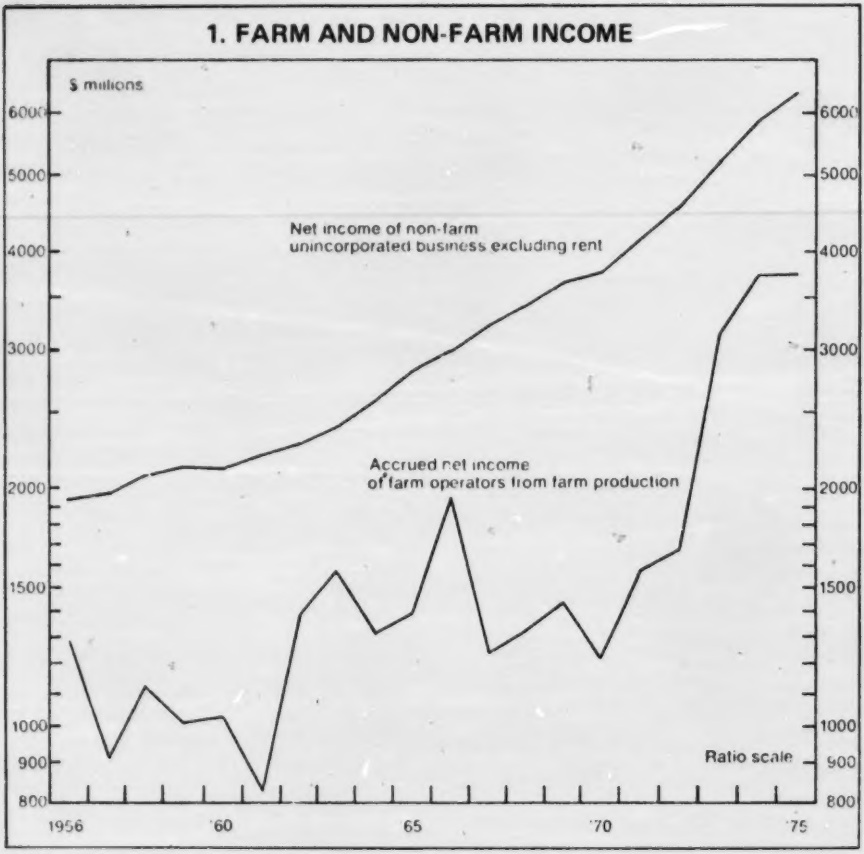
In summary, wage and price controls as a tool of stabilization policy are highly controversial; however, a few guidelines as to their role are finding increasing acceptance:

1. Enough pricing decisions are made in the market place rather than corporate board rooms, to permit a control system to be effective over a short time period without distorting income flows, creating shortgages and misallocating resources.

2. Controls alone are not a solution to inflation but can be useful in lowering expectations about the inevitability of future large increases in prices, and provide a breathing spell during which the effective anti-inflation levers of decelerating rates of increase in government expenditures and the money supply are put into operation.

Another tool of government administered stabilization policy is commodity marketing boards.

One sector of the economy that is particularly subject to variation in terms of production and incomes is agriculture. The accompanying chart illustrates the variability of farm income compared to non-farm income in recent years.



The reasons for this instability are rooted in the variability of weather conditions, the highly seasonal nature of agricultural production, the difficulty of storing surplus production of perishable foodstuffs and the fact that prices for the major food commodities, particularly grain, are set in international commodity markets that do not necessarily reflect conditions in Canada's domestic market. It is not surprising to find governments moving into this sector with stabilization policies designed to provide farmers with stable and equitable revenues and consumers with quality food at reasonable prices.

The principal stabilization instrument used is the marketing board. One of the earlier boards organized was the Canadian Wheat Board, established during the 1930s to purchase and market all wheat produced on the Prairies. Marketing boards now exist in at least one province for all major agricultural commodities with the exception of beef and corn. In addition to provincially organized marketing boards, two national marketing boards, the Canadian Egg Marketing Agency and the Canadian Turkey Marketing Agency, operate across Canada under guidelines issued by The National Farm Products Marketing Council. The various marketing boards operate under widely varying degrees of authority over production and pricing - the most highly regulated dealing with dairy products, eggs, turkey and tobacco.

While the general aims of the marketing boards, as noted above, receive broad

approval, considerable criticism surrounds many of their operations due to errors in forecasting supply and demand for certain products, thereby accentuating surplus or shortage situations. There is also a feeling among consumers that marketing boards tend to hold prices on the high side of a normal range. Many producers also resent their loss of freedom to market their products as individual producers in the most profitable market available. While some of the criticisms are probably justified, the trend appears to be toward maintaining Market Board control over major products while at the same time improving the efficiency of their operation.

Table 1

PRODUCTS UNDER MARKETING BOARD JURISDICTION, CANADA, 1976

Province:

B.C. *Dairy, fruits, broilers, eggs, turkeys, potatoes & other vegetables (10)*

Alta. *Grains, cattle, hogs, sheep & wool, dairy, broilers, turkeys, eggs & other fowl, potatoes & other vegetables (10)*

Sask. *Hogs, sheep & wool, dairy, broilers, turkey, eggs, honey(7)*

Man. *Grains, hogs, dairy, broilers, turkeys, eggs, vegetables, honey (8)*

Ont. *Winter wheat, seed corn, soybeans, hogs, dairy, broilers, turkeys, eggs, fruits, vegetables, tobacco, dried beans, tomato seedling (22)*

Que. *Dairy, broilers & turkeys, eggs, blueberries, tomatoes, pulpwood, maple products, tobacco(26)*

N.B. *Hogs, dairy, broilers, eggs, turkeys, apples, bedding plants, pulpwood (10).*

N.S. *Hogs, dairy, broilers, turkeys, eggs & pullets, tobacco, wool (7)*

P.E.I. *Hogs, dairy, broilers, eggs, potatoes & other vegetables, tobacco seed (8)*

Nfld. *Eggs(1)*

Source Economics Branch Agriculture, Canada

Monetary Policy

Reference was made earlier to the ability of the Bank of Canada to work through the chartered banks to increase or decrease the volume of money circulating in the economy. And to the fact that this ability was a powerful influence toward stabilization or destabilization of the economy. This final section deals with the techniques by which the Bank of Canada uses its power to expand or contract the money supply in carrying out its major role of stabilizing the economy.

There are two major strands of economic analysis that explain the role that money plays in influencing activity in the economy. The diagram illustrating the circular flow of income and expenditures explained how a leakage from the income stream into those savings not offset by a corresponding increase in investment or government spending, would lead to a decline in activity or a deflationary gap. An increase in the money supply operates in an indirect way to offset the short-fall in aggregate expenditures. It does this by lowering interest rates, in turn stimulating capital investment by both lowering the cost of financing investment and increasing the availability of credit. When interest rates are falling, the market price of fixed income securities is rising. Lenders are more inclined to increase their lending when the securities they receive as an asset in exchange for the dollars lent are rising in price rather than falling - as is the case when interest rates are rising.

Using this analysis the Bank of Canada runs its monetary stabilization policies by varying the rate of increase in the money supply to affect the availability and cost of credit, increasing the availability and lowering the cost when the economy needs stimulating and reducing the availability and increasing the cost when restraint is

needed. The essential point is that the modus operandi of the Bank of Canada is to affect the availability and cost of credit to commercial banks by variations in the supply of Central Bank credit so as either to stimulate or restrain the economy. Under this operating procedure, the Bank is not too concerned about the rate of monetary expansion that might be required to keep credit freely available and relatively cheap in an economic expansion. In the recent past, this approach has led to some very large and persistent increases in the money supply which have contributed to the high rates of inflation the Canadian economy has experienced in recent years.

A second approach, which lays more stress on controlling the increase in the money supply than on monitoring the availability and cost of credit, has gained adherents during the last few years of high inflation rates. This school of thought, known as the monetarist school, makes a distinction between nominal and real levels of money supply. By this they mean that what matters to those who hold money is what it can buy in terms of goods and services, and not just the dollar amount. They further argue that individuals will tend to hold a fairly stable amount of real money as a percentage of their real income. If the Bank of Canada increases the money supply to a higher level, when converted into real purchasing power, than individuals would normally hold, they will spend dollars in excess of their desired real balances and this will have the effect over time of raising prices. Similarly, lenders make a distinction between real and nominal or market rates of interest. The real state of interest is the market rate less the rate of inflation. For example, if the rate of inflation is 5% and the interest rate on a bond is 8%, the real rate of interest is 3%. One implication of this analysis is that large increases in the money supply will, over time, increase both prices and interest rates as investors demand a higher interest rate to compensate for higher inflation rates. Therefore, the fact that interest rates are rising is not necessarily an indication of credit tightness requiring a further increase in the money supply. In fact, under these conditions it is the opposite - an indication of too fast an increase in the money supply in a preceding period. This has led the monetarists to suggest that the trend in nominal interest rates is a poor indicator of whether monetary policy should be expansive or restrictive in order to stabilize the economy. The indicator they would choose is the rate of increase in the money supply. The ideal yearly rate of increase would be the amount required to finance the distribution of the increase in the total volume of goods and services under conditions of full employment. In Canada's case this is around 5%.

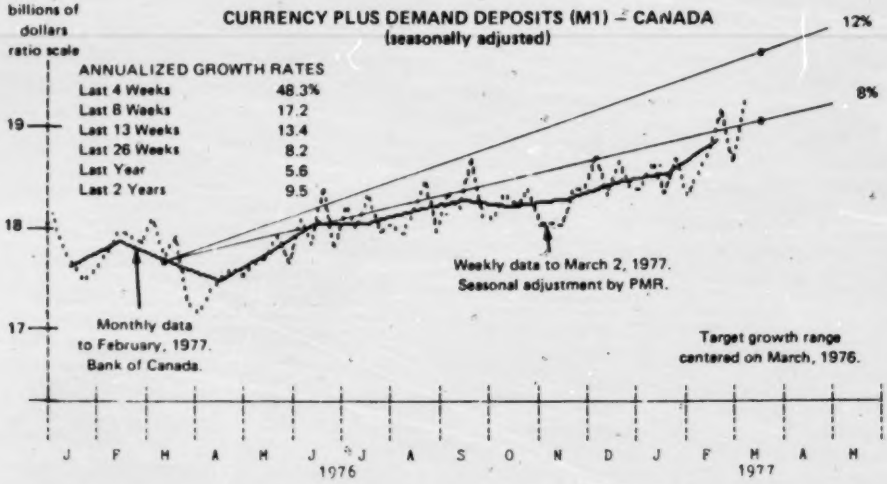
During 1975 the Bank of Canada shifted its monetary stabilization policy, to a large degree, away from interest rates or general credit conditions as the principal policy indicator, toward managing the level of the money supply. In a series of public statements in the Fall of 1975, Governor Bouey described the new policy orientation and the reasons for it as follows:

"The protection of the value of money is of prime importance to the future economic and social welfare of Canada. Whatever else may need to be done to bring inflation under control, it is absolutely essential to keep the rate of monetary expansion within reasonable limits. There is no way of preserving its value if money is created on an excessive scale. In this country the job of keeping monetary expansion within reasonable bounds is the direct responsibility of the Bank of Canada.

Between December 1974 and December 1975 the money supply increased by almost 23%, although the total volume of goods and services produced during that period increased by less than 1%."

The Bank of Canada recognized that a sufficiently high underlying rate of inflation had been built into the economic system that an abrupt deceleration in the rate of monetary expansion to the 5% figure would be very disruptive. It therefore initiated

a planned program to reduce the rate by establishing a yearly target band of rates within which the money supply would be allowed to fluctuate. The first target was set between 10% and 14%. In the Spring of 1976 the target's band was lowered to 8% - 12%. The chart below illustrates the actual rate of increase in the money supply compared to the Banks targetted range of 8% - 12%.



The technique that the Bank of Canada has chosen to control the rate of increase in the money supply is to influence the level of short term interest rates by varying the amount of cash reserves the Bank makes available to the chartered banks. To quote from the Bank's 1975 annual report -

> *"If the rate of growth of the money supply is too high the Bank can, by tightening the supply of cash reserves to the Banking system, cause short term interest rates to rise which will restrain the growth in the money supply. If on the other hand money supply growth is too low, the Bank can loosen the control of cash reserves thereby causing short term interest rates to fall and the growth of the money supply to be stimulated."*

At this point in the discussion it will be helpful to examine in more detail the relationships between the Bank of Canada and the chartered banks. It has been noted earlier that the chartered banks must keep a reserve of 12% on demand deposits and 4% on savings deposits in currency, or as a cash deposit with the Bank of Canada - known as primary reserves. These ratios were set in the revision of the Bank Act of 1967 and cannot be changed. In addition the banks must keep a secondary reserve with the Central Bank varying between 0% and 12% of chartered bank Canadian liabilities and composed of treasury bills, day to day loans and cash in excess of primary reserves. At the end of 1976 this rate was 5-1/2%

The Bank of Canada has several tools it can use to influence the cash reserve position of the chartered banks and therefore to influence the banks to either expand or contract their loans or investments.

1. **Open Market Operations**

This has traditionally been the most important control technique used by central banks. Suppose the Bank of Canada sells $10 million of government securities either directly to a chartered bank or indirectly to an investor. The cheque in payment for the securities reduces the reserves of the chartered banks held at the Bank of Canada. As each dollar of reserves can support an increase in deposits of $16-2/3 as noted earlier, a reduction of $10 million in the chartered bank's reserves with the central bank will eventually force a reduction of $167 million in deposits, and a reduction in bank loans or investments of $57 million. The process works in reverse when the Bank of Canada buys government securities from the chartered banks.

2. **Changes in the Bank of Canada's Bank Rate:**

The Bank Rate is the rate at which chartered banks can borrow from the Bank of Canada. It is also the rate that determines the borrowing cost for recognized investment dealers that trade in Treasury Bills. Such dealers can borrow from the Bank for a fifteen day period against their inventory of Treasury Bills. It is also used as a signal by the Bank to indicate, by an upward or downward movement, the direction in which monetary policy is headed - toward expansion, if the rate is reduced or toward restraint if the rate is increased. Recent changes in the Bank Act have been as follows:

1975 Jan. 13	8:25%	1976 Nov. 22	9:00%
1975 Sept. 3	9:00%	1976 Dec. 22	8:50%
1976 Mar. 8	9:50%	1977 Feb. 1	8:00%
		1977 May 9	7.50%

The increase in the rate from 8.25% to 9.50% by March, 1976 reflected the shift in Bank of Canada policy from an accommodating to a restrictive money supply strategy with the major stabilizing emphasis being placed on reducing the rate of inflation. The subsequent reduction in the rate to 7.50% by May 9, 1977 was not a reversal of this stabilization strategy but an adjustment in the rate of increase in the money supply to bring it into line with the targetted 8 - 12% growth band. The chart on page 27 illustrates how the money supply fell below its targetted growth path starting from October 1976.

3. **Transfers of the Federal Government's cash balances between the Bank of Canada and the Chartered Banks.**

The Federal Government maintains a deposit account with the Bank of Canada through which flows almost all government receipts and payments. In addition the government maintains deposits with the chartered banks to help iron out fluctuations in bank reserves due to fluctuations in Federal Government payments made by cheque. For example, if the government issues a cheque for $10 million to someone, it will be deposited in a chartered bank and will increase the reserve position of that bank and the banking system as a whole by $10 million. If such an increase in reserves is not in line with Bank of Canada policy, at a time which may be restrictive, the Bank of Canada can neutralize the increase in reserves by transferring $10 million of government deposits held by the chartered banks into the government's account with the Bank of Canada. Similarly if the government receives a cheque for $10 million and deposits it with the Bank of Canada, the banking system will lose $10 million of reserves. The Bank of Canada neutralizes this loss by transferring $10 million out of the government's account in the Bank of Canada to the chartered banks. Such a transfer is not made to a specific

bank but is distributed among all banks in accordance with a formula drawn up by The Canadian Bankers' Association. While such transfers of government deposits serve principally to iron out short term fluctuations in the reserve position of the banks due to fluctuations in the flow of government receipts and payments, it has also been used instead of open market operations to influence the level of reserves, without having the same impact on the bond market - i.e. forcing interest rates up or down - as open market operations do.

4. Moral Suasion

By moral suasion is meant the use by the Bank of Canada of its powers of persuasion over the chartered banks outside the legal framework of the Bank Act, to adopt a course of action desired by the central bank. Examples are the request by the Bank of Canada to the chartered banks in 1972 to put a ceiling on the interest rate paid by the banks on short term corporate deposits i.e. the so-called Winnipeg Agreement. No limits, in the Bank Act, are placed on the level of interest rates the chartered banks can pay on deposits. In the first half of 1972, the demand for business loans was strong and the banks were not in a strong enough liquid position to satisfy this demand. They therefore bid strongly for deposits from large corporations and others. This action distorted the relationship between bank deposits and the commercial paper market and increased interest rates at a time when the Bank of Canada was trying to hold them down in order to discourage money flowing into Canada from abroad. Another example is the request the Bank has made on occasion to borrowers in the bond market to confine the bulk of such borrowing to the domestic rather than the U.S. market. This request was made in order to cut down on the inflow of foreign capital which was pushing the exchange value of the Canadian dollar to an uncompetitively high value from the point of view of Canadian exporters.

Implications of Trade

You will remember that one of the purposes of the Bank of Canada is to protect the exchange value of the Canadian dollar. Under the present arrangement the Canadian dollar is not fixed in terms of other currencies but is free to fluctuate to reflect the demand for, and supply of, Canadian dollars by domestic and foreign users. There are two principal activities that affect the international use of Canadian dollars; one is the flow of goods and services across the international border; the other is the flow of investment capital into and out of Canada.

When a Canadian exporter sells a carload of lumber to a buyer in the United States, it creates a demand for Canadian dollars. The Canadian exporter sells the U.S. dollars he has received from the U.S. buyer and buys Canadian dollars. Conversely an importer creates a supply of Canadian dollars, as he offers Canadian dollars in the market in exchange for U.S. dollars which he needs to pay the U.S. supplier of the goods he is importing. The same process applies to exports and imports to other countries and foreign currencies. If total exports over a period exceed total imports, the demand for Canadian dollars by exporters will exceed the supply offered by importers and like any other commodity - when demand exceeds supply - the price will rise. In this case the exchange value of the Canadian dollar will increase. This value is traditionally expressed in terms of U.S. dollars since roughly two-thirds of Canada's foreign trade is conducted with the U.S. Apart from merchandise trade there are several types of service transactions such as tourist trade, interest and dividend payments on foreign investment and transportation

In 1976, Canada had a merchandise trade surplus of $1.1 billion and a deficit on services account of $5.8 billion for an overall current account deficit of $4.7 billion. In the absence of any other international financial plans this deficit, or surplus of Canadian dollars, in the exchange market would have put strong demand pressure on the exchange value of the Canadian dollar. In fact, however, the net amount of capital funds flowing into Canada in 1976, representing a demand for Canadian dollars, was initially more than enough to absorb the supply created by the current account deficit. As a result the Canadian dollar was forced to a premium over the U.S. dollar throughout most of 1976. A Canadian dollar selling at a premium over the U.S. dollar makes our exports more costly and our imports cheaper.

When the Canadian economy is operating well below capacity as it was in 1976, a premium dollar is a definite handicap. The principal source of the capital funds that flowed into Canada in 1976 was net borrowing of $8-1/2 billion in the form of long-term bonds by provincial and municipal governments and corporations. This large volume of foreign borrowing, mainly in the U.S. occurred because long term interest rates in the U.S. were around 1-1/2 - 2% lower than in Canada. During the early months of 1977, following the uncertainty created by the election of a Quebec government dedicated to separation, some narrowing of the yield spread in U.S. and Canadian rates and a marked decline in the volume of external borrowing, caused the Canadian dollar to decline to a 7% discount.

While a discount dollar is a stimulus to exports, by making imports more expensive, it increases inflationary pressures. This has created something of a dilemma for the Bank of Canada's stabilization policy. The Bank's principal policy has been to fight inflation by lowering the rate of increase in the money supply. This policy will eventually lower the level of Canadian interest rates and discourage both the international inflow of short term funds and borrowing abroad by corporations and the provinces. If Canada had a near balance on its international account, this sequence of events would not be troublesome. But when the international deficit appears likely to fluctuate in the $3 - $4 billion range over the foreseeable future, a policy that drives Canadian interest rates down to levels that discourage a capital inflow will in turn force the Canadian exchange rate down. As noted, this increases inflationary pressures, thus thwarting the main objective of Bank of Canada policy. And it highlights the major problem in stabilizing the Canadian economy at the present time: how to reduce inflation and unemployment at the same time.

SUMMARY

1. The Bank of Canada has the duty under its charter, together with the tools, to iron out fluctuations in the economy and provide the financial climate in which the economy can grow at its non-inflationary potential.
2. It attempts to do this currently by gradually decelerating the rate of growth of the money supply to the potential growth rate of the economy, which is around 5%.
3. The principal tool it uses to accomplish this is to alter the level of interest rates indirectly by expanding or contracting the amount of reserves in the banking system.
4. At the present time, the Bank is hampered in this policy by the necessity to maintain Canadian interest rates at a high enough level to attract a sufficient capital flow to finance the persistently large balance of international payments

deficit, without driving the Canadian dollar to a deep discount with the U.S. dollar - with the inflationary implications for the economy such a discount would have.

CONCLUSION

1. The Canadian economy, like those of most of the Western industrialized nations, is a mixed economy in the sense that decision making is divided between the private and public sector. Experience suggests that political and economic freedom is threatened when decision making in the public sector expands significantly above this ratio.
2. Over the years, instability in the Canadian economy has been significantly reduced by the operation of automatic and discretionary stabilizers both in the private and public sectors of the economy.
3. **Private Sector Stabilizers -**
   In the private sector the principal sources of instability in the economy include:
   a) The rhythmic fluctuations in economic activity, occurring over a three or four year period, originate in alternating periods of accumulation and liquidation of business inventories; more recently they stem from reduced cushions of excess capacity, surplus supplies of commodities and energy and financial liquidity. These factors shorten the period of maximum growth before the economy generates severe inflation or rapidly rising prices and costs.
   b) The pattern of business capital investment characterized by uneven bunching of projects has been a constant source of instability in the economy.
   c) Finally, Canada is an open economy in the sense that the volume of goods and services entering or leaving Canada as imports or exports totals more than one-half of Canada's gross national product. This fact has made the Canadian economy extremely sensitive to fluctuations in economic activity in other Western industrialized countries with whom we trade. In the past, these economies were normally at different stages in the business cycle - some expanding and some contracting - thereby dampening the impact on the Canadian economy. During the early 1970s, however, the business cycle became synchronized on a world scale, with all countries entering an inflationary boom condition and the inevitable deflationary downward adjustment simultaneously, greatly magnifying the destabilizing impact on the Canadian economy.
4. In the private sector, the principal automatic and discretionary stabilizers at work in the economy include:
   a) the slow pace at which consumers alter their spending patterns in response to increases or decreases in their incomes.
   b) the availability of computers to speed up the collection and analysis of an increasing flow of statistical information has enabled business people to recognize and partially adjust to periods of business fluctuations in such areas as inventory and business capital spending policy.
   c) the relatively stable trend in dividend payments by corporations compared to large fluctuations in corporate profits has been a stabilizing factor in income generation.

   These stabilizing influences, while positive, have not been powerful enough to more than somewhat dampen the amplitude of fluctuations in the economy. A more powerful assist has been provided by automatic and discretionary stabilizers in the public sector.

5. **Automatic Public Sector Stabilizers**

a) On the income side the personal tax system is a powerful automatic stabilizer drawing income from consumers during boom periods, thus slowing the pace of business activity, and cushioning the decline in personal incomes in recessionary periods.

b) On the expenditure side the most important automatic stabilizers are the unemployment insurance program, family allowances and welfare income support payments.

6. **Discretionary Public Sector Stabilizers**

a) The two big traditional levers of government stabilization policy are fiscal and monetary policy. When private sector spending is insufficient to employ fully the resources of the economy, the government budget is moved into a deficit position either by increasing expenditures or reducing tax revenues. In the absence of an inflationary situation, the move to a fiscal deficit would normally be accompanied by an easing of monetary policy by increasing the reserve position of the chartered banks. In the environment of slow growth, high unemployment and slowly decelerating but still high inflation that characterized the 1976-1977 period, the problem of implementing the correct mix of stabilizers was a complicated one. There was a general feeling in both business and labour circles, that the price and wage controls program had become counterproductive with regard to providing the level of capital invesment and creation of new jobs required to reverse the high and rising level of unemployment.

In this situation, the Bank of Canada re-affirmed, as its major policy goal, continuation of its restrictive anti-inflationary policy while the Federal Government moved mildly toward a more expansive fiscal policy through a combination of regional job creating expenditures and specific tax cuts.

b) Government legislated price and wage controls have been imposed in several western countries during the past decade as a desperate last effort to halt a strong inflationary trend which seemed to be resistant to the traditional restraint of the operation of supply and demand pressures in the marketplace. One school of economic thought attributed this failure to the growth of monopoly powers of big business and big labour that enabled them to force high prices and high wages onto the consuming public, irrespective of the underlying supply and demand pressures in the marketplace. Another school identifies persistent inflation with excessive growth in the money supply, either by the willingness of the central bank to accommodate excessive credit demands of an overstimulated economy or by its obligation to facilitate the financing of an inflationary rate of growth in government expenditures. While wage and price controls continue to be controversial in discussions of stabilization policy, there is general agreement that they are effective for only a short period - two to three years - after which they produce distortions and inequities in the generation and distribution of incomes and in the production process. There inequities far outweigh the short-term real and psychological anti-inflationary thrust of the control program.

c) A so-called stabilizing technique that has a long and often disastrous history as a palliative for inflation has been the technique of indexing money incomes and payments to fluctuations in the cost of living. This is a technique used in economies experiencing persistent and strong inflationary trends to try to protect the real buying power of income receivers. If indexing of all forms of

income is adopted as the sole response to persistent inflation, ignoring more fundamental anti-inflation policies of fiscal, monetary, price and wage restraint, the expected result will be hyper-inflation. If left unchecked, hyper-inflation will lead to inevitable breakdown of the system as its cost escalates beyond the ability of the economy to support it. If indexing of incomes is limited to protecting those on fixed incomes at the lower end of the income scale, it can, in conjunction with other anti-inflation policies, reduce economic suffering and inequities that are caused by persistently high rates of inflation.

d) A traditional area of discretionary fiscal stabilization policy has been the production and marketing of agricultural products. The great variability from year to year in the volume of production of farm products due to variations in climatic conditions, from hot to cold, wet to dry, attracted government intervention to try to iron out the consequent fluctuations in farm income.

Europe has a complex system of subsidies, quotas and production controls designed to stabilize farm incomes. During the early post war years the United States also had a broad range of agricultural income support programs. In more recent years it has dismantled many of these and returned production and marketing decisions to the discipline of the market place. By contrast the Canadian Government in recent years has moved more heavily into the establishment of marketing boards, production quotas and price controls in an attempt to both raise and level out fluctuations, in farm income.

There is considerable controversy in agricultural circles, concerning the advantages and disadvantages of increased government intervention in the production and marketing of farm products, compared to relying primarily on the allocation mechanisms of the market economy. However, as long as erratic variations in climatic conditions influence the volume and quality of agricultural products, there will be a need for some form of discretionary government stabilization policy, particularly in the area of financing the build-up of surplus stocks of storable commodities to be used in years of poor growing conditions.

SUMMARY

This commentary has described some of the more important reasons for instability in the Canadian economy and the more important stabilizers, both automatic and discretionary, that operate to dampen the amplitude of fluctuations in the economy. The varied and close economic and financial ties between Canada and other countries, particularly the United States, limit the ability of Canadian stabilization policy to cushion the economy completely against fluctuations that occur in these external economies. Nevertheless, given this restriction, there is lots of evidence to suggest that Canadian stabilization policies have fallen well short of attaining the objective of an economy consistently growing at its full employment, non-inflationary potential. The greatest current challenge for stabilization policy is to stimulate the job creating potential of the economy without regenerating strong inflationary pressures.

Governments alone cannot accomplish this. What is required is a cooperative effort by all major participants in the economy — consumers, labour, business and governments — to create a climate of incentive, opportunity and energy. This climate must be grounded in a recognition that individual demands on the economy cannot exceed the capacity of the domestic economy to satisfy.

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